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HOUSEHOLD ECONOMIC STRESS INDEX

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Household Finances Still In Good Shape, Even With Faster Inflation

SUMMARY

- The PNC U.S. Household Economic Stress Index* increased to 1.7 percentage points in the first quarter of 2017 from 1.2 percentage points in the fourth quarter of 2016. This is still well below the long-term average of 3 to 4 points
- Rising inflation accounted for the increase; faster home price appreciation and a lower unemployment rate helped ease financial stress somewhat.
- Twenty-eight out of thirty-four PNC regional markets were at their trend HESI levels in the first quarter of 2017; five markets had HESI values better than their respective trend and one mark market was classified as "stressed".
- The HESI will likely tick higher through the remainder of 2017 and 2018 as house price appreciation cools and inflation gradually speeds up.
- PNC Economics forecasts that the HESI will approach its "normal" rate in 2018, as the economy reaches full employment, consumer price inflation increases and house prices rise in line with income and demographic trends.

PNC's U.S. Household Economic Stress Index (HESI)* increased to 1.7 percentage points in the first quarter of 2017 from 1.2 points in the fourth quarter of 2016 as consumer price inflation accelerated (Chart 1). The first quarter is the last full quarter where historical data are available. Though the index level increased slightly, it is still well below the 4 percentage point score we would expect to see when the economy is growing at its trend rate. According to the U.S. HESI, financial pressures have been well-below the long-run rate since 2013 and so the slight increase can be interpreted as a movement toward normal economic conditions. The PNC U.S. Household Economic Stress Index is designed to measure the amount of stress household budgets are feeling in response to changing macroeconomic conditions.

The HESI's increase in the first quarter was largely due to higher prices at the gas pump propelling an increase in consumer price inflation. The national average unleaded gasoline price rose from $1.86 in the first quarter of 2016 to $2.31 in the first quarter of 2017, a 24 percent increase. As a result, inflation according to the consumer price index accelerated to 2.6 percent on a year-over-year basis in the first quarter from 1.8 percent in the fourth quarter of 2016 and just 1.1 percent in the first quarter of 2016. Besides energy prices, inflation pressures are moderate. Excluding volatile food and energy prices, consumer prices rose 2.2 percent on a year-over-year basis in the first quarter, its fifth consecutive quarter growing at that rate. The core PCE price index, which is the Federal Reserve's preferred inflation measure, rose by just 1.8 percent in the first quarter. This is below the Fed's 2 percent inflation target.

Rising home prices are helping homeowners build wealth because for many people their home is their biggest asset. Strong housing demand pushed up the national S&P/Case-Shiller home price index 5.6 percent on a year-over-year basis in the first quarter of 2017, compared with a 5.3 percent increase in the fourth quarter of 2016 and a 5.2 percent increase in the first quarter of 2016. Home sales are trending higher, but builders have struggled to keep pace with the increased demand (Chart 2). With inventories tight, homes do not last long on the market and buyers are bidding up prices.

A strong labor market is another support to household finances. Payroll job growth averaged 166,000 jobs a month in the first quarter of 2017, an increase from the 147,000 jobs a month average during the fourth quarter of 2016. Although the unemployment rate held steady at 4.7 percent between the fourth quarter of 2016 and the first quarter of 2017, this was

* Household Economic Stress Index = (unemployment rate) + (CPI inflation rate) – (Case-Shiller home price index rate of change). A higher value indicates a higher level of stress.

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because the faster job growth was offset by new entrants into the labor force. The labor force participation rate increased to 63 percent in the first quarter of 2017 from 62 percent in the fourth quarter of 2016. This is a good thing as increases in the labor participation rate typically mean that individuals have greater confidence in the labor market and the economy in general. Another sign that the job market is in good shape is that there were 5.8 million job openings in the first quarter, up 4 percent from the previous quarter and one of the highest levels since the series begin in 2001. With that many job openings, employers are offering higher wages to attract talent.

Most regional economies across PNC's footprint have settled into their trend rates of economic growth. After re-indexing the HESI to account for different regional economic structures, twenty-eight out of 34 PNC market areas had HESI values in the first quarter that are consistent with their long-term averages. This is an increase of one market from the previous quarter but it is the same number of markets as in the first quarter of 2016. Since 2015, the number of regional economies performing at trend has ranged from 25 to 29 as the U.S. economy continued to grow at a moderate pace (Chart 3).

Five out of 34 market areas had HESI scores better than their trend rate in the first quarter, compared with 7 markets in the previous quarter and six market areas in the first quarter of 2016. Northeast Pennsylvania, Southwest Michigan and Baltimore shifted from trend growth to stronger-than-trend growth, thanks to faster home price appreciation. Conversely, Delaware, Northern New Jersey, Philadelphia, Southeast Florida and Tampa Bay markets transitioned from stronger-than-trend growth in the fourth quarter of 2016 to trend growth in the first quarter as home price appreciation decelerated in those markets.

The Central Illinois market was the only region to be classified as "stressed" in the first quarter (Chart 4). The market was classified as "stressed" in the third quarter of 2016 as well and is the only market to slip into this category since mid-2014. Home prices have barely risen since the end of the Great Recession and the regional labor market is distressed. Well-paying jobs in the region are concentrated in heavy machine manufacturing but the industry has been shedding jobs since 2012 because lower commodity prices around the globe caused demand for heavy machinery to slump. The recently passed state budget provides a potential bright spot for the future. Public construction projects will come offline after sitting idle due to lack of funding. This could boost demand for heavy machinery and lead to employment and wage gains. These, in turn, could lead to higher home prices and less financial stress for households in the region.

PNC Economics estimates the U.S. HESI declined to 0.3 percentage points in the second quarter as inflation decelerated because of cheaper cell phone data plans and lower pharmaceutical drug prices.

The U.S. HESI will likely remain at 0.3 percentage points in the third quarter and increase to 1.2 points in the fourth quarter. Thereafter, the HESI is forecast to rise steadily throughout 2018 to reach 3.6 points in the fourth quarter of 2018. Even as the HESI moves up in the coming quarters, it is important to note that it will be moving toward its "normal" level of between 3 and 4 percentage points. This means that household finances will remain in good shape over the next year and a half.

The HESI's steady rise over the next 12 to 18 months will be driven mostly by slower house price appreciation through the remainder of 2017 and 2018. Home prices will rise in line with income and demographic trends as the inventory of "cheap" housing diminishes. Rising mortgage rates will erode affordability and cool demand somewhat. At the same time, homebuilding will increase in response to tight inventories.

Despite a healthy pace of job growth, the unemployment rate will only gradually decrease as labor force growth partially offsets job creation. The unemployment rate is expected to decline from 4.4 percent in the second quarter of 2017 to 4.2 percent in the fourth quarter of 2017 and 4.1 percent in the fourth quarter of 2018. Consumer price inflation will likely remain below 2 percent in year-over-year terms until the first half of 2018 and will rise to slightly higher than 2 percent in the second half of 2018 as gasoline prices increase, a tighter labor market supports income growth and aggregate demand, and the pricing power of firms strengthens.

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Chart 1: Though Rising, Financial Stress Remains Low

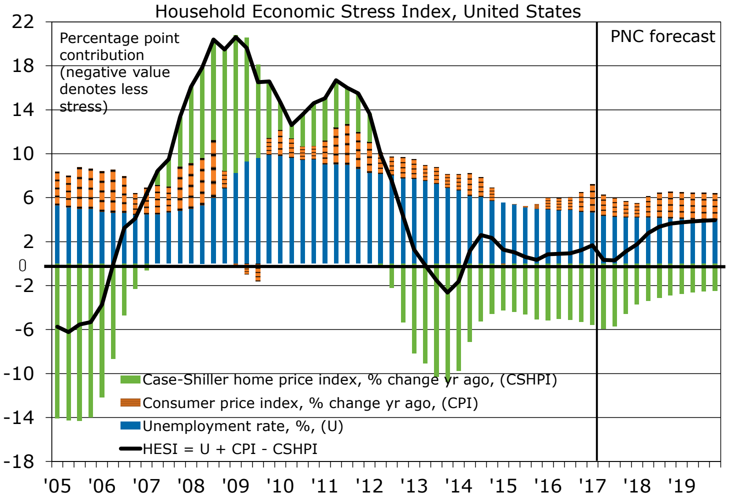

Chart 2: Home Sales Have Outpaced Construction for a Few Years

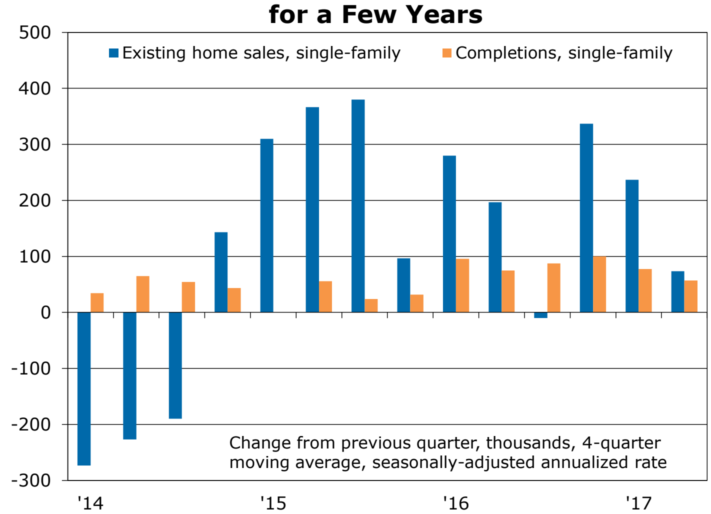

Chart 3: PNC Footprint Has Been Mostly Stable Since 2015

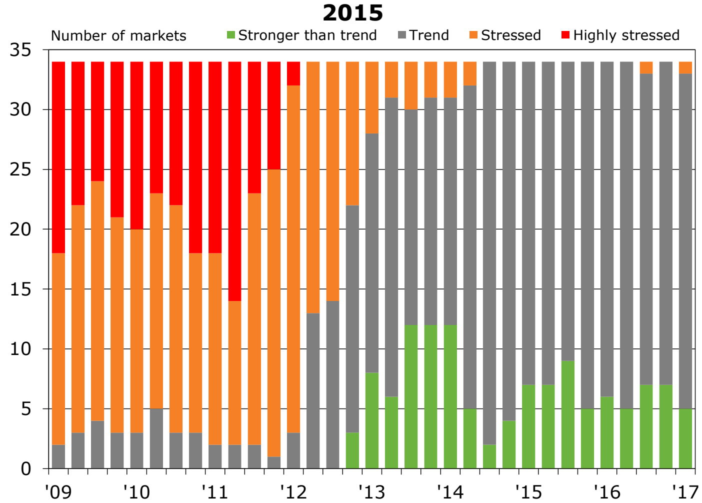

Chart 4: Central Illinois Experiencing High Levels of Economic Stress

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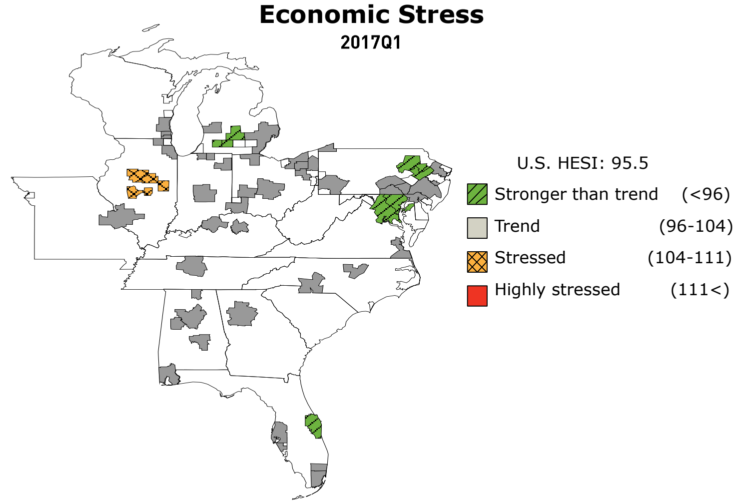

Chart sources: Bureau of Labor Statistics; Fiserv, Inc; Bureau of Census; Moody's Analytics; National Association of Realtors; The PNC Financial Services Group

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